

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Wiggins Analyst: John Pavalasky Bill Number: AB 1239
Related Bills: See Legislative History Telephone: 845-4335 Amended Date: April 8, 2003
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Payment Instruments

SUMMARY

This bill would allow a bank to create a business trust to hold the securities reserves that it is required to hold under California law.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to remove bank reserves from bankruptcy attachment.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2004, and would apply on or after that date.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve the implementation concerns discussed in this analysis.

ANALYSIS

STATE FINANCIAL CODE

Under the state Financial Code, banks are required to hold (own) securities at least equal to the total loans made by the bank, whether payable in United States currency or foreign currency. The bank must own the securities solely and exclusively in its own right, both of record and beneficially. If the security is owned of record by a documented nominee of the bank or by certain kinds of securities depositories, the bank is nevertheless treated as owning that security.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director
Gerald H. Goldberg

Date
04/24/03

FEDERAL/STATE TAX LAW

Existing federal and state law imposes tax on individuals, estates, trusts, corporations, and certain business entities and each is treated as a distinct entity for tax purposes. Although an estate or trust is a taxable entity, it is nevertheless a conduit of income to be distributed. Income received during the year is taxed to the estate or trust unless distributed. A deduction is allowed for distributed income, which becomes taxable to the beneficiary receiving the income.

Business or Commercial Trusts

A “business” or commercial trust may be created as a means of carrying on a profit-making business, usually using capital or property supplied by the beneficiaries. The trustees or other designated persons are, in effect, managers of the undertaking, whether appointed or controlled by the beneficiaries. Also, that “business trust” may be taxable as a corporation or a partnership or, if owned by a single entity, the separate existence of that “business trust” may be disregarded for federal and state income and franchise tax purposes under federal regulations commonly referred to as “check-the-box regulations.”

Additional California Rules

Sourcing Rules

Tax is imposed on the entire taxable income of residents of California regardless of source. However, only the taxable income of nonresidents (including nonresident trusts) derived from sources within California is taxable. A trust having a resident beneficiary is fully taxable on its income by California regardless of whether the trust is administered in this state.

Every corporation and limited liability company taxable as a corporation either organized, qualified to do business, or doing business in this state is subject to the corporate franchise tax, which is imposed for the privilege of doing business in California. The corporate franchise tax is not imposed on a corporation’s income, but instead it is measured by a corporation’s California source net income.

California Tax Rates

The tax for individuals and trusts is computed on a graduated scale at rates ranging from 1% to 9.3%.

The franchise tax rate is generally 8.84% for corporations. Financial institutions pay a higher rate, commonly called the “bank rate,” equal to the franchise tax rate plus 2%. Currently, the rate is 10.84%. The financial rate is designed to equalize the tax burden between financial institutions that are not subject to personal property taxes and license fees, with nonfinancial corporations that must pay these local taxes and fees.

The tax rate for S corporations is 1.5%. Limited partnerships, limited liability partnerships, and limited liability companies not classified as a corporation for tax purposes pay an annual tax equal to the minimum franchise tax of \$800.

Corporate Income Tax

The tax rate for the corporate income tax is 8.84%. That rate is applied to income derived from California sources by the following entities:

- corporations that are not organized in or qualified to do business in California and are not doing business in California, and
- certain non-corporate business entities (such as business trusts classified as corporations).

Check-the-Box Rules

SB 1234 (Stats. 1997, Ch. 608) enacted conformity to federal “check-the-box” entity classification, which generally provides that whatever entity classification is adopted at the federal level must be used for California purposes.

Delaware Business Trusts

Because of the special nature of laws governing trusts, Delaware has become the leading state in which business trusts are formed. Delaware is one of the few states that allow trusts to continue for an unlimited duration and allows the creator of the trust to direct the trust investments. In most states a trust has a limited term and the trustee (not the creator of the trust) must make the investment decisions. There is also favorable tax treatment under Delaware law, as follows:

- There is no state income tax on dividend or interest income accumulated in, or capital gains earned in a Delaware trust.
- Delaware does not impose sales, use, or intangible personal property taxes on assets held in the trust.

THIS BILL

As amended, this bill would allow a bank to be treated as the owner of the securities held in a business trust that is limited in purpose to paying the paying instruments issued by the bank, and the beneficial interest in the business trust is solely owned by the bank. In other words, a bank would be allowed to create a business trust to hold the bank’s statutory securities reserves as long as the bank is the sole beneficial owner of the trust.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

Significant but apparently unintended consequences would arise under California tax law from this change to the Financial Code, as follows:

1. Classification of income subject to franchise tax versus income subject to corporate income tax.

Earnings on a bank’s statutory reserves are currently treated as business income subject to the franchise tax. If the reserves are in the form of federal securities, such as T-bills, the interest income is included in the measure of the franchise tax.

Interposing a business trust to hold these reserves could arguably change the incidence of the tax from the bank to the trust. The argument could be advanced that the trust is at the election of the taxpayer under the check-the-box regulations, classified as an association and subject to the corporate income tax. However, federal and state bond interest is not taxable under the corporate income tax.

2. California source income versus income sourced outside of this state.

If the business trust holding these reserves had a commercial domicile outside this state, the argument could be made that the income constitutes intangible income that has its source outside of this state and, thus, is not taxable by California but is taxable by the state in which the business trust is commercially domiciled.

3. Creation of “nowhere” income.

If the business trust were commercially domiciled in a state having no income tax, the earnings on the bank reserves would never be taxed by any state, thus creating “nowhere” income.

The following amendment would prevent these implementation issues from arising.

On page 2, after line 25, insert:

SEC. 2. Section 23038.8 is added to the Revenue and Taxation Code, to read:

Section 23038.8. Notwithstanding any other provision of law (including subdivision (b) of Section 23038), for purposes of Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 18401), and Part 11 (commencing with Section 23001), the separate existence of a business trust holding an eligible security of the taxpayer pursuant to Section 33561 of the Financial Code shall be disregarded, and all activities, assets, liabilities as well as items of income, deduction, and credit of the trust shall be treated as activities, (including activities for purposes of Section 23101), assets, liabilities, and those items, as the case may be, of the taxpayer that is the sole owner of the beneficial interest in the business of the trust pursuant to Section 33561 of the Financial Code.

OTHER STATES' INFORMATION

Pending

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

Due to data limitations, revenue losses reflect general order of magnitude. The total impact of this bill is on the order of \$150 million annually beginning in 2004.

Revenue Discussion

For the 2000 tax year, banks and financial institutions reported \$1.28 billion in apportioned interest income from U.S. securities and \$51.9 billion in other interest income apportioned to California.

Assuming that most of the interest income from U.S. securities is due to holding securities required under the state Financial Code, and taking into account that some portion of the other interest reported is due to holding state securities required under the state Financial Code, interest income from securities that are required to be held under state Financial Code could be well over \$1.5 billion.

If those securities were held in a business trust, as proposed under this bill, the income from those securities would then not be subject to the corporate franchise tax, which is imposed for the privilege of doing business in California. Multiplying the \$1.5 billion interest by the financial rate of 10.84% results in a tax impact that would exceed \$150 million annually.

ARGUMENTS/POLICY CONCERNS

The change to the Financial Code to achieve one result should not have, as an unintended by-product, the ability of banks to completely eliminate the tax on earnings from bank reserves. The amendment suggested under the heading IMPLEMENTATION CONSIDERATIONS would resolve this issue. It is a fundamental principle of taxation that “substance” should control the tax consequences of an action rather than the “form” that is adopted for that action. Stated differently, a person should not be able to achieve by indirect means a result (non-taxable income) that it could not be achieved directly.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335
john.pavalasky@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov